

Letting Free Market Work: The Need for Policy and Legal Reform

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Changes in the Business Climate Effected over the Past Ten Years

If asked whether life in post-communist countries has improved over the past years, most people would invariably say "yes." Despite frequent grumbles and a still disturbing number of the destitute, we can see that people dress better, eat better, build better houses, drive better cars, have better holidays...

It is also obvious who is behind all these changes - these are people who work and create. It doesn't matter where and how a person works - be it running a business, treating patients, baking bread, teaching children or selling newspapers - because any kind of work broadens the basis for well-being. Naturally, small business has a prominent role to play as well. It allows those who got deprived of their sources of income to find one. It offers goods which used not to be produced and services which used not to be rendered. Small enterprise is one form of activity which allows people to reap the fruits of such efforts.

Sadly, all too often answers to the question whether it has become easier for people to work, create and thus to secure well-being for themselves and others are negative. In most cases, the blame for this is put not on "unfavourable circumstances" nor on other factors outside our control but on people's elected government.

The collapse of socialism marked the beginning of a new era for millions of people. It freed private initiative and opened up opportunities for people to pursue freedom and well-being. Lithuanians, just like other post-socialist nations, got on the right track, ready to assume responsibility for their own lives and thus help create a free and prosperous society.

Over the past few years, however, regulatory and operational rules for private business activity have aggravated, bringing in more state interventions, obstructing market entry, and shackling business growth. Presently, attempts to launch and run a business are beset with a whole range of binding problems and constraints.

What does Small and Medium-Sized Enterprise Expect from the Government?

Drawing on the findings of policy research in many different areas, the Lithuanian Free Market Institute (LFMI) has come a conclusion that small and medium-sized enterprises are faced with the same problems in conducting their activities as large corporations. These concerns include complicated and ambiguous tax rules and high taxes, over-regulation, stringent employment requirements, barriers to market entry, and a multitude of other restrictions. These problems are particularly painful and annoying for budding entrepreneurs. For this reason we even tend to use the term "starting and developing businesses" instead of "small and medium-sized enterprise."

In December, LFMI carried out a sociological survey among Lithuanian entrepreneurs and the public to elicit their attitudes to, and judgements on, the business climate in Lithuania. High tax rates, bureaucracy, a lack of starting capital, constantly changing laws and insufficient safety of business activity ranked highest among the problems confronting businesses in Lithuania. Only one of these problems, a lack of starting capital, is not directly related to the activities of government. The last concern is due to the government doing a bad job of its major responsibility - the protection of life and property. The three remaining problems are directly caused by government. I suppose any other country (and not only in Eastern Europe) would get similar results. This suggests very clearly that people and businesses are in favour of limited government and do not expect the state to be an almoner of gifts or favours.

The biggest obstacles to business activity (reported by entrepreneurs)

	Percent
High taxes	78.6

Constantly changing laws	68.9
Bureaucracy	59.9
Insufficient safety of business activity	41
A lack of starting capital	39.2
Corruption	31.6
Competition	28.3
Restrictions on specific areas of business	27.9
Source: LFMI's survey	

What is the Proper Role of Government in Promoting SME?

The results of the survey indicate that all governments should do in order to encourage business activity, and particularly new initiatives, is to lower taxes, deregulate the economy, thus reducing bureaucracy and solving the problem of constantly changing laws, and strengthen its function as a watchdog in preserving rules of just conduct. Unfortunately, every government I know has so far been redesigning the economic system not only in this but also in the opposite direction.

Take Lithuania as an example. Over the past years Lithuania has made significant progress in economic transformation. Let me mention the liberation of market forces after a 50-year era of central planning. The process of restitution and privatisation is in full swing. We have witnessed a significant improvement, in macroeconomic terms, of the environment for private sector development. The stability of the national currency has been achieved through the introduction of a currency board arrangement back in April 1994 (Bulgaria is also implementing similar measures in order to reduce inflation and stabilise the domestic currency).

However, essentially no attempts have been made to dissolve huge old monopolies in infrastructure and municipal service delivery and to remove some sectors of the economy from public ownership. What is still worse, regulatory and operational rules for private business activity have aggravated, obstructing market entry and shackling business growth. In their attempts to launch and run a business activity, firms are faced with a whole range of binding constraints. All this must have prompted the attitudes voiced by business leaders during the LFMI's conducted survey. They hold that the business climate was more favourable at the outset of market reforms, or right after the collapse of the command economy, than it is now. It stands to reason that removal of these obstacles would improve significantly business conditions, furthering economic growth and increasing the benefits derived from it by the general public.

Where Reforms Are Needed Most

All over the region, including Lithuania, unfavourable conditions for business development are attributed first and foremost to: (i) unfair competition and government interventions in the economy in the form of restrictions on market entry and operational constraints; and (ii) rampant bureaucracy, erecting an insuperable barrier mostly for starting and small-scale businesses, inviting corruption, and undermining market forces.

Let us look at some evidence of how businesses are being discouraged from settling in and growing.

Market Entry: Registration and Licensing

The licensing maze. Market entry is blocked from those willing to undertake independent business activity by a mass of restrictions: permissions, licenses, registrations, consents, certificates, approvals, warrants, notifications and, no doubt, many others. A multiplicity of convoluted procedures for starting and operating a business make people waste their energy and resources on discharging meaningless and excessive requirements. The mishmash of bureaucratic regulations hurts mostly starting and small or medium-sized enterprises, which often find it beyond them to fulfil all regulatory requirements imposed by the government.

Licensing of tourist agencies provides a good example of how senseless and inconsequential licensing is. The issue of a tourism license in Lithuania requires the fulfilment of three major conditions. The office of a tourist agency cannot be located in an apartment. Every agency must have a fax machine and a telephone. In addition, the owner of a tourist agency is required to have higher education and two years of working experience in the tourism area. In addition to that, an applicant must submit a number of documents (eleven in this particular case) plus a list of the firm's employees, although at this stage the

firm-to-be may not have hired any employees at all. The latter requirement suggests that a firm which is not yet operating, and thus making no money, must have hired employees and remunerate them for work. Under such circumstances, many potential firms never get to doing business. Those who eventually do squeeze into the market are under a constant pressure of keeping up with ever-changing operational rules. They must also renew their licenses every year and be ready for new licensing charges and new requirements attached to the issue of a license. Developing long-term business strategies becomes virtually impossible, thus impeding the development of the whole sector.

Officialdom at work. Many governmental agencies at the municipal and national levels possess powers which permit them to issue the above-mentioned documents and to decide whether to allow or not businesses to enter the market. As a result, licensing procedures are complex, inconsistent and repetitive. Due to the intricacies of the licensing system, registration of businesses and the issue of licenses in and of themselves are mere formalities required for statistic purposes. It does not give a right to commence a business activity, nor does it verify conformity with the terms of entering the market or readiness to start up a firm. Instead, it inflicts a number of excessive requirements that a firm-to-be must discharge in order to qualify for a permission to operate.

In addition to that, licensing is imposed not only on those types of businesses which are specified by law. Other activities, such as gathering mushrooms and berries, may be subject to licensing by ministerial decrees. Naturally, it is completely unacceptable that any institution can apply or introduce various forms of licensing at their own discretion.

Moreover, licensing regulations particularise the areas of activity in excessively minute detail and are even subject to territorial and institutional gradation, which multiplies the number of permissions and consents one is obliged to obtain before launching a business undertaking.

No logic behind licensing requirements. The order of discharging obligations and requirements attached to the registration and issue of licenses is illogical and inconsistent. Many conditions that need to be fulfilled while applying for a license or registering a firm are, in their essence, operational procedures which cannot be discharged prior to launching a business. Licensing thus fails to serve its sole purpose of consumer protection. My point is clearly illustrated by the example with tourist agencies. Licensing of restaurants affords another example. To qualify for a license, a restaurant-to-be must comply with a number of hygienic and technological requirements. At the stage of establishment, however, a restaurant may not have all necessary equipment or technological facilities, especially in terms of food preparation standards.

Licenses to make money. A range of licenses exists which are used for the purpose of rationing scarce budgetary resources. Licenses thus obstruct market entry and induce shadow activity on the part of those who fail, or are in no position, to obtain them. A license for retail trade in alcoholic beverages costs over 10 thousand litas (2,500 US dollars), which is quite a lot for starting businesses. Let me mention that the same requirement is applicable to the initial stock capital. The import of alcoholic beverages requires a license too. A limited number of licenses are sold in auctions. The prices in the latest auction peaked at 300 to 500 thousand litas.

Abuse of power. The issue of permissions, consents, certificates and other official documents is predicated on vague rules, leaving the applicant at the mercy of authorities, who possess powers to interpret the requirements. This provides an open invitation to corruption and abuse of power.

Businesses entangled in constant bureaucracy. Licenses must be renewed every year. Each year the conditions and costs of obtaining a license or some other permission change, causing a great deal of uncertainty concerning the future and severely constraining firms in setting long term objectives. Once a business has been launched, it gets under the compulsion to deal with the bureaucratic nightmare every year. Every year a small private restaurant serving national dishes must obtain a license to serve beverages. Suppose a bank loan has been taken to start the business. The owner does not know whether he will be able to repay the loan, given that charges for licenses may increase considerably or the entrepreneur may appear to be unable to comply with all requirements.

Needless duplication. Licenses and permissions are issued not only to allow business entities to operate in the market but also to launch products or to carry out professional activities. For example, a building company which holds a license to perform construction work needs a number of permissions for specific processes and undertakings. The procedures for obtaining them involve a sequence of almost 30 approvals and warrants that take over a year to obtain. An architect who works for a building company and has to oversee a building project must receive a special permission.

Operational Requirements

Enterprises are burdened with an increasing number of requirements to provide information to all levels of authorities. They are also confronted with all kinds of inspections (labour safety, fire prevention, etc.) carried out by various government agencies. Operational requirements are ambiguous and dispersed among a whole range of institutions. Thus, compliance becomes cumbersome, time-consuming and pointless. On-site inspections are used on a wide scale. They are based on fairly vague rules, thereby allowing the authorities concerned to make discretionary decisions. Collecting and submitting reports and various information as well as check-ups carried out amidst a busy period disrupt business activity and may even paralyse it.

Competition Principles

Competition principles are another source of concern. It is obvious that life in society must be based on a system which does not constrain the producer's opportunities to manufacture and to sell nor the buyer's freedom to buy or not to. In practice, however, the understanding of these principles often differs. A requirement to sell goods at a fixed price, for example, may be viewed as an infringement of ownership rights. On the other hand, prohibitions against fixing prices may be regarded as an encroachment on the freedom of contract.

The central objective of the dominating approach to competition (both in the European and American doctrines) is to outlaw any agreements that restrict competition and any abuse of a dominant position. In addition, it promotes control and stresses the need to secure "fair" competition. However, for these elements to be implemented, it is necessary to constrain freedom one way or another, disregarding the fact that freedom of contract is the key value that is supposed to be protected by law in general and competition law in particular.

The said concept, based on competition law, has more flaws to it. For one thing, regulation of relationships is invariably complicated and bureaucratic. Second, the system of norms is contradictory in itself. The wish to adhere to the principles leads to absurdities, which, in turn, result in making exceptions. The description of such exceptions becomes, in terms of content and space, more important than the establishment of basic norms themselves. Third, some prohibitions are totally unjustified and for some societies unacceptable. Fourth, efforts to restrain market leaders ultimately do harm to consumers. The operational conditions of the leaders are worsened, and coercive contest over prices eliminates large-scale competition whereby new alternatives are offered to existing products. Finally, competition rules are extrinsic to human nature. They are not understood as naturally fair and righteous. They are known inasmuch as they are regulated by law. Such rules are never too effective and are often dodged, thus bringing in disharmony in the system of social norms.

One should remember, however, that even the position of apparent leaders is rather equivocal in the market, given that the development of new technologies constantly provides the consumer with new means to achieve the same ends. For instance, a monopoly position in the post market is worthless if there exist such mediums of communication as telephone or e-mail. The railway can enjoy a monopoly only as long as there are no buses, aeroplanes or private cars.

Obviously, a free market entry unfettered by state-dispensed privileges is an essential condition of competition. This condition is in most cases hampered by licenses, tax barriers (customs and stamp duties), state aid, concentration of demand in government, and petty standards which oust from the market not so much poor-quality goods as different ones. Agreements between undertakings rank behind these barriers. In addition, when speaking about agreements, there is one essential distinction that is overlooked: Some of agreements are forced upon others, while others are not. No doubt, it is the first group that involves most danger.

It would seem logical that efforts to protect competition should be prioritised in the same order as possibilities to abuse free competition (see above). Competition rules should be targeted first and foremost at fighting government-imposed restrictions. Forced contracts and coercion used by private institutions should be the next cause of concern. Voluntary agreements should come last. In reality, however, it's quite the reverse. Competition rules are, unfortunately, targeted only at the activities of private businesses which violate the principles of free competition, while a number of provisions allow government bodies to intervene in economic affairs and infringe on the conditions for free competition by means of financial and legislative levers. Instead of safeguarding competition, the state thus distorts it.

Take the Telecom's monopoly (which is, as a rule, introduced alongside privatisation in East European countries), an increase in import duties or new corporate welfare programmes. For this reason, fighting the infringements of competition on the part of the state is the most pressing and challenging of all tasks. Freedom of contract, on the contrary, should be rehabilitated.

I have given here some examples of unjustified regulations. Sadly, there are many more areas that are suffering from inappropriate controls. These are employment regulations, price controls, unfair competition on the part of the government, barriers imposed on foreign trade, etc. All this is no longer rules of just conduct, as should be prescribed by law, but rather technological instructions which are only one step from central planning.

The Unattainable Ends

The motivation and rules of licensing as presented by official institutions suggest several primary purposes for which licensing is ostensibly used. These are: to protect consumers, to generate budget revenues, and to manage economic information. Analysis of licensing procedures shows that these ends cannot adequately be achieved by means of licensing.

The government's wish to protect consumers is unattainable on the ground that it is impossible to predict and regulate every single instance of harm incurred by consumers. Moreover, such attempts entail a number of pitfalls. They create misleading impressions of safety and encourage consumers to suspend their own judgement. It is also a costly method in economic terms as it augments public spending and imposes extra costs on businesses. Ultimately, government interventions prevent the rise of more effective private security mechanisms, such as competition, private information business, voluntary organisations for consumer rights protection, etc. The LFMI's survey of business people shows that only 2.5 percent of entrepreneurs deem government interventions useful for the consumer, while all others oppose the declared aims of regulation.

	Percent
The state	37.1
Officialdom	32.2
Government	21.6
Monopolies	4.6
Nobody	4.2
Customers	2.5
Competitors	1.4

The second aim of generating public revenues may be achieved by enhancing the efficiency of tax administration and by properly managing information. It is not necessary to license businesses in order to collect budget revenues. Taxes can do the job. Otherwise, part of resources is wasted away on the licensing system itself. The number of potential taxpayers shrinks as a result of restrictions on market entry. Finally, all this escalates the business community's dissatisfaction with official policies.

Information management can be implemented by such means as an integrated register, legally and technically regulated exchange of information among state institutions, standardised data gathering, etc. Sadly, these measures have failed to be implemented so far, since energy and resources have been squandered on ill-judged solutions such as licensing.

The wrong solutions

The Lithuanian government has come under continuous pressure to improve the business environment, but mostly by buttressing private businesses with public funds and providing various types of tax breaks and exemptions, soft loans, seed capital, and other forms of assistance. As a result, a number of corporate welfare programmes have been launched and government funds have been established to support private enterprises. Yet, these programs fail to bring desired results. Confronted with market forces, they produce adverse effects and bolster corruption, connected lending, and personal favouritism.

Corporate welfare programmes are, as a rule, limited to, and available for, selected or politically connected groups, thus creating uneven conditions for the ineligible and undermining free competition. Aid funds, tax relief and other privileges for one group are provided at the expense of all others. They place a heavier tax burden on all taxpayers and divert government resources from financing common public needs. Corporate welfare programmes are based on the belief that the development of the private sector can be enhanced by taking superficial, short-sighted measures and neglecting to challenge the problems inherent in the system. They also augment government authority-and consequently bolster corruption-by giving it a mandate to expropriate and redistribute more than it used to. Once assistance programs have been put into motion, they inevitably engender more demand and thus the need for more budgetary revenues and public spending. Ultimately, terminating government aid becomes hard and politically unacceptable.

All corporate welfare programmes build on existing weaknesses and fallacies in government's approach to private enterprise. The need for measures of other kind is obvious.

Needed Policy Actions (the Principles of Reform)

Instead of expanding the corporate safety net and introducing fragmentary and arbitrary tax breaks, exemptions and privileges, it is essential to remove all barriers to market entry and operational business constraints and thus provide equal and favourable conditions for all enterprises. This approach requires that free market powers, and not bureaucrats, rule and guide.

Specifically, let us look at how licensing may be revised to allow free market solutions better the business environment. Many of the desired objectives of licensing may be attained not through licensing but by other less onerous means: by shaping a tradition of disclosing information to consumers rather than the state, by promoting private information disclosure and quality rating agencies; by reinforcing the institute of civil liability and indemnification. An appropriate legal regulation would reduce risks at the roots rather than at the surface.

LFMI proposes eight criteria for a critical review of licensing:

1. To apply licensing to a business activity only if the end in view can adequately be achieved by means of licensing. To assess the expediency and utility of the said aim prior to licensing and to specify it in licensing legislation.
2. To repeal licensing powers used for fiscal and consumer protection purposes. If not, to define concrete sanctions to be taken against the licensing institution if the quality of a licensed product fails to meet established norms. To eliminate functions, such as information provision and control of business partners, imposed on businesses through licensing.
3. To designate by law a single institution responsible for licensing and to define responsibility for injury caused by actions of the said institution.
4. To prohibit state institutions from imposing additional licensing requirements and to define explicitly licensing requirements as indicated in the Company Law.
5. To establish by law rather than by supporting legislation the main rules of licensing as well as the criteria for refusing to issue or for revoking (suspending) a license. To define explicitly such criteria so as to preclude arbitrary interpretation. Rather than imposing some extra conditions, licensing must be used to verify compliance with the requirements established by law.
6. The grant of a license should require compliance with requirements that are logical and attainable prior to the commencement of a licensed business activity.
7. To repeal the renewal of licenses.
8. To adhere to the principle that any activity that is not forbidden is permitted and so to define forbidden instead of legitimate activities.

Dealing with business problems which are caused by government is quite tricky. It seems, on the one hand, that for these constraints to be removed, the state just has to do... nothing. On the other hand, the state is quite reluctant to give up some of its powers, therefore decisions are either postponed or never taken. Often as not, we even witness examples to the contrary, that is, we witness the state expand its authority. In most cases, decisions to liberalise the economy are taken only when a collapse caused by regulation is inexorable. We suggest thinking in due time.

As Nobel prize winner Friedrich August von Hayek said, we have two opportunities: chaotic order or planned chaos. It is obvious that the first choice is a free market, the latter implies free and active

government. Several years ago Eastern European nations made their choice and are still committed to it. Let them remain post-communist, not post-market, nations.